Bandid Nijathaworn: Macroprudential policies and capital flows – managing under the new globalization

Remarks by Mr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at the Conference on Macroprudential Policies, organised by the People's Bank of China (PBC) and the International Monetary Fond (IMF), Shanghai, 18 October 2010.

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Thank you Chair,

First, let me thank the PBC and the IMF for the invitation. It is an honour to be here, and to be given the opportunity to share my view on this panel.

Given time limitations, and the fact that capital flows are important developments in the region at this time, I want to use this opportunity to discuss three issues. The ***first*** is the context of the current capital flows to Asia. The ***second*** is managing capital inflows and the role of macroprudential policies, where I will draw on Thailand's recent experience. And the ***third*** is my view on what we need to do to deal more effectively with the capital flows challenge.

At this time, capital inflows to Asian emerging markets have been large and persistent, posing challenges for policy. The first challenge involves a macroeconomic dilemma that centres around the tension between appreciation pressures, inflation development, and growth prospect. The second stems from financial stability concerns associated with potential build-ups of macroeconomic imbalance, risk of asset price bubbles, and the possibility of an abrupt reversal of inflows. In the past, as we have seen here in Asia, serious reversals have triggered debt defaults, banking distress, and currency crises.

Although capital flows are nothing new for Asia, what is new and makes the issue more demanding this time is the global context that the flows are taking place, which has important implications for the effectiveness of the policy response.

First, compared to previous episodes, capital inflows this time are not country-specific that relate to the financing of payment deficits. Instead, capital inflows this time are a global phenomenon propelled by near zero policy rates and liquidity expansion in the advanced economies, as well as the return of risk appetite, and the recognition that risk-adjusted investment returns in the advanced economies are likely to be very low for an extended period. This means we are living in a world where the forces that shape the resurgence of capital inflows lie outside the control of policy by emerging markets, making it a totally different challenge.

Second, given that financial markets have become more integrated and more interconnected than ever before, the risk to economic and financial stability associated with capital inflows this time is also much greater. This is because large capital inflows relative to the absorptive capacity of any economy are more likely to be sustained for a longer period. As a result, the effects of abrupt reversals of capital inflows are likely to be more severe as well. Such reversals, abrupt or not, are bound to happen once better growth prospects in the advanced economies are confirmed. The upshot is that we are living in a world where disruptive tail events can be more of a frequent occurrence than was the case in the past.

And ***third***, while the forces underlying the current cycle of capital flows are global, policy response in emerging economies remains domestic-centric. This, I think, is an important point to note in the current capital flows episode. Also, because financial markets are more integrated, policy response in one country can have significant unintended consequences on other economies. In other words, we are living in a world where events and policies in a country can result in large spillover effects on other economies.

So, this is the new economic and financial context in which the flows are taking place and the policy responses are being shaped. Managing this will be a challenge, and effective policy response will require an integrated approach that combines flexible monetary and exchange regime, fiscal policy, capital account liberalization, and the use of macroprudential measures, in a coherent policy framework. Moreover, the policy response will need to be supported by structural reforms and policies to enhance the depth, the resilience, and the strength of the domestic financial system, as well as policies to promote a greater degree of product and labour market flexibility. In this context, macroprudential measures constitute only one of the many policy tools that will have to be used.

Let me now turn specifically to macroprudential policies. One noted feature of the approach to deal with capital flows in the current cycle is the recognition that an effective and responsive prudential framework can help contain the build-up of financial risk and vulnerabilities that a boom in capital inflows typically generates. This includes the use of "microprudential" instruments to help keep individual banks strong, or to seek to contain system-wide risk through "macroprudential" measures. Policy tools to serve both purposes are many: all of which aim either at moderating procyclical financial behavior or at enhancing the banking sector's resilience to shocks on both the asset and the liability sides.

Drawing on Thailand's recent experience on macroprudential policies, I would like to make three comments.

First, it is important, in the context of public communication, to make a clear distinction that macroprudential measures are different from capital controls. Technically speaking, macroprudential policies apply to the calibration of regulatory measures from a system-wide perspective to dampen procyclicality arising from the interplay between the business cycle, the financial cycle, and risk-taking behavior of economic agents. Given such interpretation, measures to curb or discourage capital inflows should be considered as capital account measures and not macroprudential. For example, Thailand's recent measure to reimpose withholding tax on non-resident investment in the bond market is a policy to discourage capital inflows.

Second, macroprudential measures work by reducing systemic risk across the financial system. To this end, they are useful tools to lean against the wind of excessive credit growth and asset price increases. As we know, monetary policy alone is not adequate to ensure financial stability, and the policy rate can be too blunt a tool to deal with asset price increases because of the adverse effects on the economy. Therefore, combining macroprudential measures with monetary policy offers a useful approach to help contain financial vulnerabilities and overcome the trade-off that arises when inflation development is not consistent with asset price increases or rapid credit growth.

To illustrate with a Thai experience, the Bank of Thailand has adopted inflation targeting under a flexible exchange rate regime, and has combined this with macroprudential measures in our monetary policy framework since 2000. So far, the approach has worked well. From our experience, when properly designed, macroprudential measures can complement traditional monetary policy while supporting the functioning of the financial system.

To date, we have successfully used macroprudential measures on several occasions. For example, in 2003, rising high-end real estate prices together with strong mortgage lending growth led us to impose a ceiling on the loan-to-value (LTV) ratio for residential property with transaction price exceeding ten million baht. Then, between 2004 and 2005, concern about household debt prompted us to tighten regulation on credit cards and personal loans by limiting credit lines not greater than five times the applicant's average monthly income.

My ***third*** comment is to acknowledge that there are practical difficulties in identifying the trigger points for implementing macroprudential measures. Here, the challenge lies in selecting a set of indicators that can condition a timely policy choice, given the discrete nature of the instruments. To this end, we have put in place a macro-surveillance system to monitor vulnerabilities in seven key areas; namely, property market, stock market, banking sector, non-financial corporate sector, household sector, government sector, and external sector. Indicators are used to evaluate the build-up of vulnerabilities and imbalances in these sectors and the need for macroprudential measures is then assessed. This ultimately boils down to a judgement call. For us, integrating macroprudential measures in the overall macroeconomic modelling exercise to ensure a consistent and timely policy outcome remains a key priority.

Finally, I want to come back to the point I raised earlier about the global nature of capital flows and the national orientation of policy. This is an important point and applies both to emerging markets and advanced economies. Simply put, the current cycle of capital flows has a strong international dimension as a key driving force of capital flows is the exceptionally low interest rates in the major economies. Hence, policy response by emerging markets is made more demanding if the problems at the source remain.

Therefore, given the potential destabilizing influence that capital inflows may have on emerging markets, a question that must be asked is whether there are gains to be had for the global economy as a whole in moving away from exclusively domestic-oriented policies? As we know, the literature on international monetary policy cooperation indicates that there are gains to be made from policy cooperation, though the size of the potential benefits is subject to considerable debate. On the other hand, the lack of policy coordination will lead to sub-optimal outcomes. The relevant question is then why not greater international coordination of monetary policy to ensure sustained global growth and stability? Similarly, for emerging markets Asia, a question can be raised about the gains that can be had from greater coordination of macroprudential policy standards on a regional basis, as a way of dealing with the macro-implications of capital inflows from a financial stability perspective.

I do not have firm answers to these questions. But at a time when emerging markets are increasingly being relied upon as the engine of global growth, I think discussion on any initiatives that lessen the vulnerability of emerging markets economies to boom-bust cycles would be in the global interest.

Thank you.